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Globalization in a Post-Pandemic World: Risks and Opportunities

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RISKS AND OPPORTUNITIES

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This article explores the manner in which deglobalization is unfolding—and suggests ways in which investors can mitigate the risks, as well as seize opportunities, that may arise in a more fractured world.

Even before the coronavirus pandemic hit in earnest in early 2020, there was notable evidence that globalization—the tenet that had buttressed 30 years of global economic progress—was unwinding, and that rising protectionism would lead to decreases in global growth.

In particular, all five pillars of globalization are under threat or, in some cases, have even been declining: trade in goods and services; capital flows that drive, fund, and fuel cross-border foreign direct investment (FDI); immigration; a commitment to global rules and standards (the spread of ideas); and the stature of multilateral institutions such as the World Bank and International Monetary Fund (IMF).

As deglobalization has taken hold during the past decade, policy-makers and economists have become worried about the outlook for global growth. Concomitantly, investors have grown fearful about the prospect of declining asset returns over time.

This article explores the manner in which deglobalization is unfolding—and suggests ways in which investors can mitigate the risks, as well as seize opportunities, that may arise in a more fractured world.

Concerns about global growth were in place before the pandemic, as the global economy struggled to rekindle growth levels enjoyed before the 2008 Global Financial Crisis. In 2019, the IMF cautioned that global growth has fallen sharply, affecting advanced and developing economies. The evidence of weak growth underpinned and underscored the IMF's own warning back in 2011 that global economic growth "will never again reach the rates of global growth observed before 2008."[1] And in a similar vein, the consulting firm McKinsey predicted in 2014 that global growth rates over the next 50 years would be just half that seen in the previous 50 years.[2] More worryingly, growth forecasts for developed and large emerging economies—those with at least 50 million people—were, with only a few exceptions such as China, generally trending below the 3-percent annual rate of growth needed to double per capita incomes in a generation (approximately 25 years).

Meanwhile, investors and market observers also were worried about global prospects and what weak economic growth forecasts mean for asset returns. A 2016 report by McKinsey, for example, forecast that a confluence of macroeconomic factors—including high levels of debt and slow rates of economic growth—would lead to an era of low investment returns.[3] According to the McKinsey projections, annual real-equity returns in the United States and Europe would decline from an average of 7.9 percent between 1985 and 2014 to 4.0–6.5 percent in the United States and 4.5–6.0 percent for western European equities out to 2036. Across the same period, real returns from fixed income were projected to fall nearly 400 basis points, from 5.0 percent and 6.0 percent to 1.7 percent and 1.6 percent in the United States and Europe, respectively.

FIVE PILLARS OF GLOBALIZATION

In the aftermath of the Global Financial Crisis, slowing economic growth and declining economic standards led governments around the world onto a path of deglobalization. Facing growing populist pressure, many have adopted protectionist policies they hoped would shield their local industries and workers. Against this backdrop, the pandemic and the ensuing dire economic environment has accelerated the trend toward a more de-globalized, nationalist, and balkanized world. The continual attraction of protectionist measures amid low growth means the recent election of U.S. President Joe Biden may not reverse the global tide of more deglobalization.

Moreover, given forecasts of even further declining economic growth on the back of COVID-19, it is reasonable to assume that the post-pandemic era will be characterized by more steps toward deglobalization as greater protectionism is entrenched across the five pillars.

GLOBAL TRADE OF GOODS AND SERVICES

In global trade of goods and services, for instance, the World Trade Organization has partly blamed slowing trade growth since 2018 on "new tariffs and retaliatory measures," noting that global trade growth has flatlined in the past decade at around 3 percent.[4] Furthermore, global trade agreements are fractured beyond the ongoing U.S.–China trade dispute, and global trade treaties are moving toward more bilateral or regional negotiations and less multilateralism. According to McKinsey Global Institute, the share of goods produced around the world and traded across borders has fallen sharply, from 28.1 percent in 2007 to 22.5 percent in 2017.[5]

For example, on the back of Brexit, the United Kingdom is in negotiations independently with the United States and Japan. And the Trans Pacific Partnership (TPP) has created a selective agreement for preferential trade access by 11 countries including Singapore, Japan, Australia, Mexico, and Canada. With rising concerns of increasing global economic hardship due to the pandemic, governments are being forced to respond to populist pressures that further encourage deglobalization and protectionism policies around the world.

GLOBAL CAPITAL FLOWS

Global capital flows also are being pressured and disrupted in a world that is becoming more siloed. DHL's Global Connected Index, which provides a comprehensive and up-to-date view on the state of globalization, was pulled down in 2018 by decreased capital flows, notably in FDI. Global FDI fell for three consecutive years, from US$2 trillion in 2016 to US$1.3 trillion in 2018.

Capital flows to developing nations also have declined on the back of the COVID-19 pandemic.

In terms of FDI, the United Nations Conference of Trade and Development FDI to developing economies stalled in 2019 compared with the previous year at $695 billion. More than US$83 billion flowed out of emerging market (EM) debt and equity investments during March 2020, according to the Institute of International Finance.[6] Furthermore, according to the Pew Research Centre, the pandemic will drive a 20-percent fall in global remittances, which tend to flow from rich countries to poor—from US$714 billion in 2019 to an estimated US$572 billion in 2020.[7] Reduced international capital flows make it harder for borrowers with dollar debt to make their repayments; and without access to meaningful global capital, countries will struggle to fund investment and drive economic growth.

Relatedly, governments, including many in emerging markets, are coming under pressure to protect and preserve capital, and the question for some governments is whether they should resort to hiking capital controls. Both China and Argentina have measures in place. For example, China's central bank increased controls after its devaluation of the yuan in 2015, making it harder for Chinese citizens to buy U.S. dollars. In September 2020, as part of a broader public debt restructuring package, Argentina imposed currency controls as a way to bolster central bank reserves and help stabilize its economy.

IMMIGRATION

Over the past decade, immigration, too, has come under explicit threat, making it harder to hire the talent to support businesses and the human capital needed to drive economic growth. An anti-immigration stance has led to policies such as former U.S. President Donald Trump's "Buy American and Hire American" executive order of 2017, which restricted the entry of highly skilled workers into the United States. In Europe, anti-immigration sentiment contributed to Brexit, and rising populism has fueled a marked change across the political spectrum in Austria, Poland, Hungary, and Germany with a swing toward leaders who favor closed borders. As Brexit takes effect in 2021, U.K. employers will face new hurdles recruiting staff from the global talent pool.

GLOBAL RULES AND STANDARDS

There is also a notable decline in the commitment by governments to global rules and standards. This places at risk the spread and transfer of the best ideas across the world, a key to productivity. Specifically, there is the emerging threat of a splinternet: that within the next decade, the internet will fragment, creating competing Chinese-led and U.S.-led technology platforms and segregated intellectual property protocols. Such a technological fragmentation will further disrupt global supply chains, adding to the damage caused to them by the economic slowdown that has been the response to the pandemic. A splintered world also will hamper and slow innovation. New developments and products would have to be enacted across separate platforms with separate protocols—or reach only half of the global marketplace, limiting the scope of efficiencies. This is a further example of the world becoming more balkanized and nations acting in competition rather than in cooperation.

STATURE OF MULTILATERAL INSTITUTIONS

The final pillar of globalization, multi-ateralism, is in retreat and facing the emergence of rival institutions that challenge the power and influence of traditional global institutions such as the World Bank and the IMF. China's Belt and Road Initiative,[8] the establishment of the BRICS Development Bank,[9] and China's decision to make loans and enter swap contracts linked to the renminbi are just a few examples of how China is moving away from the existing global regime and becoming a dominant player in the world order.

These efforts pose a direct challenge to the global regime that for the past

75 years has largely been governed by the Bretton Woods institutions. Traditionally, these western-led organizations were seen as the pre-eminent source of international capital. However, the Chinese-led institutions are offering vastly more sums of capital, leaving traditional multilateral institutions with reduced influence and leverage. Today, China is the largest trading partner and foreign direct investor for many developed and developing countries. Moreover, China is now the largest lender to the U.S. government and the largest creditor to emerging markets—more than any one of the Paris Club, the World Bank, or the IMF.[10]

As more nations turn to unilateralism and bilateralism over multilateralism, the power of multilateral institutions is at risk of diminishing. This is reducing global coordination and the ability for nations to come together to tackle global challenges such as climate change and pandemics. Indeed, amid COVID-19, the diminution of globalism has been further revealed in the distinct absence of a more coordinated global approach among countries, as nations across the world favor unilateralism and national agendas take primacy.

Global coordination overseen by multilateral organizations engenders transparent and consistent rule-based economic regimes that reduce the cost of operating globally. It therefore follows that deglobalization creates complexity and makes it more expensive for businesses to operate across borders.

FORTUNES WILL BE MADE

Despite the gloomy global economic picture brought about by deglobalization, fortunes will still be made. There remain investment opportunities that promise attractive real, risk-adjusted dollar returns even in a more siloed world.

Against the backdrop of a deglobalizing world, investors and asset allocators should consider three ideas in particular: First, sharpening their existing portfolios and skewing allocations to company stocks that will benefit, and removing those stocks that will struggle, in a more deglobalized world; second, scaling back allocations to geographical regions that depend on globalization, and therefore would be economically challenged in a more siloed world—in particular emerging markets; and third, gaining exposure to regions that will excel in a deglobalized world—specifically, China.

As a first port of call, asset managers will need to revisit and question their existing portfolios with a view to upgrading the portfolios to reflect the stocks that will win in a more siloed world. Additionally, they will wish to sell out of company stocks that are positioned to lose top-line revenue or low-cost advantages that are rooted in a globalized strategy. Some companies might be able to retain strong profitability in spite of a margin squeeze from deglobalization, but it will be vital to assess the potential impact of the greater protectionist trends.

Those who are picking stocks need to ask how those stocks react to the weakening of each of the five pillars of globalization. This would involve investors examining how companies can expect to change and which contingencies they might have in place for each pillar.

For example, with respect to rising trade protectionism, what are the impacts of both broken-down supply chains and the growing scrutiny of where a company produces and sells its goods? In terms of capital, what emerging hurdles may exist for companies raising and investing capital across the globe? Furthermore, with respect to the risk of the splinternet, how will a company manage operations in a world of separate and competing IP protocols?

With these questions in mind, companies that tend to operate under a more devolved, rather than centralized, organizational structure have greater scope to succeed in an emerging deglobalized world. For example, a company that allows local subsidiaries to borrow and invest in local markets will be better able to maneuver and operate in a segregated business environment.

A second aspect to portfolio shaping is more thematic reallocation of capital away from areas predisposed to benefit from globalization. In this light, the EM asset class is a significant exposure to reconsider because developing markets usually have relied on the pillars of globalization for growth, including FDI and trade.

Perhaps unsurprisingly, EM economic fundamentals—in the face of deglobalization—already were weakening before the pandemic.

Perhaps unsurprisingly, EM economic fundamentals—in the face of deglobalization—already were weakening before the pandemic. EM and developing economies' growth was recorded at 3.7 percent at the end of 2019, despite the World Bank forecast of 4.4 percent at the start of the year. Amid the continuation of the pandemic, emerging economies are expected to contract by 3 percent in 2020, with Brazil's gross domestic product (GDP) falling 9 percent, South Africa's by 8 percent, and Russia's by 6.6 percent.

Furthermore, EM assets have a record of underperformance, particularly over the past decade. EM equities have underperformed relative to other stock market indexes and relative to EM bonds. The MSCI Emerging Market Index has returned annualized average returns of just 2.5 percent compared with the 13.6-percent average annual return of the S&P 500 since the start of 2010. Meanwhile, over the same period, EM debt returned 5.53 percent, according to the JP Morgan Emerging Markets

Bond Index, which tracks the performance of hard currency EM sovereign debt.

CHINA

One exception, of course, is China.

Many U.S. portfolios remain underweight in their exposures to China. According to investment adviser Seafarer, Chinese securities account for less than 1 percent of the total portfolio of U.S. investors.[11] U.S. investors own around 2 percent of the local Chinese stock market, compared with the average roughly 18-percent U.S. ownership of the local stock markets of advanced economies.

According to IMF forecasts for 2020, China was still set to grow by 1.6 percent while the world as a whole suffered a 4.4-percent fall in GDP.

The case for China is, notwithstanding, compelling—built around a sound economic base and projections of strong asset returns.

China has strong economic fundamentals and projections of strong returns. Furthermore, given its size and its ability to rely on the growth of its domestic population and markets, China is somewhat immune to the severe risks of deglobalization. In that respect, investing in China can be seen as an antidote or hedge to deglobalization.

China is the only major economy not to have suffered economic recession amid the pandemic. According to IMF forecasts for 2020, China was still set to grow by 1.6 percent while the world as a whole suffered a 4.4-percent fall in GDP. In addition, the IMF projects that China will bounce back to more than 8-percent growth in 2021, which puts the Chinese economy firmly back on the path to double per capita income well within a generation. In October 2020, China reported third-quarter growth of nearly 5 percent. In terms of future equity performance, projections point to positive real risk-adjusted equity returns that rival other major stock market returns.

In September 2020, China's stock market hit a new record high of more than US$10 trillion. Even at this stage Chinese stock markets reflect only a quarter of U.S. stock market values. According to JP Morgan Asset Management, China's equities are projected to deliver close to double-digit annual investment returns over 10 to 15 years, as the economy approaches becoming the world's largest, in absolute terms. And because China is forecast to continue to deliver superior nominal economic growth relative to other markets, JP Morgan Asset Management projects 8.1-percent returns for the part of the domestic market (onshore stocks) known as A shares.[12]

China's increasingly consumer-led economy offers attractive stock investing opportunities in a liquid and now more-accessible market—food staples, construction, and consumer discretionary. To put this in context, consumption as a share of GDP in developed economies such as the United States is around 70 percent; its record low was in 1952 when it was 58 percent. In China, however, this number remains below 40 percent. In addition, China is leading in areas of technology such as facial-recognition in artificial intelligence. Moreover, the Chinese political class is devising and implementing policies such as the technology-focused Made in China 2025 plan[13] that will continue to support a trajectory of strong economic growth.

Chinese multiples also are comparatively cheap and attractive. China's blue chips are trading at a significant discount to the 35 times multiple of the S&P 500. According to Refinitiv, Chinese corporate profits could rise by 18.8 percent in 2021, up from 10.5 percent in 2020.[14] In comparison, European and U.S. earning growth are forecast to stay below 2019 levels.

Chinese equities offer clear diversification benefits, especially for U.S. dollar-based investors. However, investing in China does present its own set of risks.

First, there is a debate across the investment industry about whether investing in China complies with rising environmental, social, and governance (ESG) standards. Some asset allocators assert that the country's human rights record and approach toward the environment rules Chinese investments out of their portfolios. However, other investors are willing to give China the time to adapt to ever more-stringent ESG rules, and they invest in Chinese assets taking the view that the country is on a path to converge on better standards. For example, in September 2020 the Chinese government announced plans to hit peak CO_2 emissions in 2030 and achieve carbon neutrality by 2060—the first time it has committed to a goal to tackle climate change.

Second, investors will need to mitigate the risk that China is a rigged or insiders' game. Another downside risk to investing in China is the opacity of the country's economic structure, which can leave foreign investors at a disadvantage to locals. In essence, investors are considering whether to put capital in an environment that is unpredictable and largely un-hedgeable.

Investors can counter these concerns by entering the Chinese market with local partners who offer insights into how the markets really work. Chinese regulators appear to be acutely aware of these governance shortfalls: They have pledged to refine the rules for corporate governance of listed companies.

However, the ultimate risk that investors need to manage is the fragmentation of the global economy.

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To be sure, China has a vested interest in the prevailing economic system. In 2019, for example, China's trade surplus stood at around US$422 billion and its exports of goods totaled a record high of almost US$2.5 trillion. In the same year, China's export of goods and services represented 17.4 percent of its GDP.

Nevertheless, were the world to fragment, China remains best positioned to survive and thrive in a globalized world—more so than most emerging and even developed market economies. In this regard, investing in China is the antidote to deglobalization.

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